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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1952.

No. 397

R. H. ERNEST, TRUSTEE IN BANKRUPTCY FOR NATIONAL PETROLEUM RESERVES CORPORATION, BANKRUPT, PETITIONER,

VS.

RIVERVIEW STATE BANK, A CORPORATION, RESPONDENT.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT AND BRIEF IN SUPPORT OF PETITION.

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VS.

RIVERVIEW STATE BANK, A CORPORATION, RESPONDENT.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT.

To the Honorable Fred M. Vinson, Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

Your petitioner respectfully shows:

I.

SUMMARY AND STATEMENT OF MATTER INVOLVED.

The National Petroleum Reserves Corporation was duly adjudged a bankrupt in the U. S. District Court of Kansas on March 27, 1951, and a Trustee in Bankruptcy chosen. The Bankrupt had previously, on August 30, 1945, executed and delivered a chattel mortgage covering oil and gas leases and machinery in four counties in Kansas securing a note of $250,000.00 to The Riverview State Bank of Kansas City, Kansas, on a R. F. C. loan (R. 13 to 23). Said mortgage was recorded as a real estate mortgage and also filed as a chattel mortgage in each of four counties in which the leases were located, more than four months before bankruptcy and renewal affidavits as required by statute for chattel mortgages were filed out of time, but before any rights of creditors intervened.

The Bankrupt later, on December 8, 1945, gave two additional chattel mortgages, termed assignments as additional collateral security for the above indebtedness on oil and gas leases in Ellis and Russell Counties, Kansas (R. 23 to 26). These later assignments were recorded as real estate mortgages, but never were filed as chattel mortgages in said Counties (R. 5).

The Trustee in Bankruptcy claimed the right to receive the oil runs from all the leases, and that the assignments as additional collateral were void as to the Trustee because not filed as chattel mortgages in Ellis and Russell Counties as required by the Laws of the State of Kansas.

The Bankrupt had executed division and transfer orders in favor of the creditor Bank (R. 26 to 38), but

the creditor Bank never had possession of any of the leases or property thereon, or oil produced therefrom (R. 41).

The Referee in Bankruptcy held the assignments as additional security were void as to the Trustee in Bankruptcy under the laws and decisions of Kansas, but held the creditor was entitled to the oil runs under the mortgage filed as a chattel mortgage in the first four counties (R. 44 to 55). The United States District Court for the District of Kansas sustained the holding of the Referee (R. 9) and both parties appealed from the rulings adverse to them to The Court of Appeals.

The Court of Appeals, Tenth Circuit, reversed the District Court as to the assignments as additional collateral security and affirmed it as to the oil runs from the leases in the four original counties (opinion, R. 59 to 69).

As stated, this is a proceeding in bankruptcy and the Court of Appeals has entered its decision herein and the questions herein involved are of the utmost importance to all Banks and other lending agencies loaning money on oil and gas leases, to all oil well supply companies and to creditors of bankrupts, and the decision of the Court of Appeals is in direct conflict with the Kansas decisions and abrogates the Kansas Statutes.

II.

JURISDICTIONAL STATEMENT.

The statutory provision believed to sustain the jurisdiction of this Court is Section 1254 of Title 28 of the United States Code. The Statute of the State of Kansas which is rendered nugatory by the decision of the Court of Appeals of the Tenth Circuit is *Section 58-301, General Statutes of Kansas of 1949*, the applicable portions of which read:

> "Every mortgage or conveyance intended to operate as a mortgage of personal property, which shall not be accompanied by an immediate delivery and be followed by an actual and continued change of possession of the things mortgaged, shall be absolutely void as against the creditors of the mortgagor, and as against subsequent purchasers and mortgagees in good faith, unless the mortgage or a true copy thereof shall be forthwith deposited in the office of the register of deeds of the county in which the mortgagor resides, and also in the county where the mortgaged property is located at the time the mortgage is executed * * * but if the mortgagor does not reside in this state then the mortgage shall be recorded in the county in which the mortgaged property is situated at the time the mortgage is executed."

The date of the judgment sought to be reviewed by certiorari is July 18, 1952, based upon an opinion rendered by the Court of Appeals of the Tenth Circuit, July 10, and amended July 18, 1952, in cases Nos. 4401 and 4402. Case No. 4401 being entitled in said Court, Riverview State Bank, a Corporation, Appellant, vs. R. H. Ernest, Trustee in Bankruptcy for National Petroleum Reserves Corporation, Bankrupt, Appellee, and case No. 4402 being entitled in said Court, R. H. Ernest, Trustee in Bankruptcy for National Petroleum Reserves Corporation, Bankrupt, Cross-Appellant, vs. Riverview State Bank, a Corporation, Cross-Appellee, and the judgment of said Court rendered August 4, 1952, overruling the Petition for Rehearing filed in said causes, said cases having been appealed upon one transcript of the record, consolidated for argument and one opinion filed covering both cases, which at this date has not been reported in the Federal Reporter but the opinion of the Court of Appeals appears in the record (R. 59 to 69). The date of this application for certiorari is October 7, 1952.

III.

QUESTIONS PRESENTED.

The questions herein presented are:

(1) The Trustee in Bankruptcy holds the position of a most favored creditor (not controverted).

(2) The rights and priorities of creditors are controlled and determined by the laws and decisions of Kansas. (This is not controverted.)

(3) In Kansas an oil and gas lease is personal property.

(4) Being personal property in Kansas, a mortgage on an oil and gas lease is a chattel mortgage in Kansas and by express statute such a mortgage is absolutely void as to creditors until filed as a chattel mortgage, irrespective of actual notice of such mortgage, except in cases not applicable to the case at bar.

(5) The two later mortgages given as additional collateral security did not purport to cover the drilling machinery, equipment, casing and the like on the leases in Ellis and Russell Counties, which are definitely personal property and specifically made so by the leases themselves. Said two later mortgages not having been filed as chattel mortgages are certainly void as to the Trustee as to such personal property, even though they are held to be valid as to the leases themselves. The Trustee contends they are not valid even as to the leases as to him.

(6) The fact that an oil and gas lease "affects" real estate and is therefore entitled to be recorded under the Kansas recording statutes, and such record imparts constructive notice of such lease, such recording does not

breathe validity into a mortgage on such lease that is absolutely void as to creditors having notice of such lease.

(7) Oil and gas "in place" is not owned or possessed by a lessee in an oil and gas lease until severed from the land; therefore oil and gas in place, being migratory cannot be mortgaged by the lessee in an oil and gas lease until actually reduced to possession and then can be covered only by a chattel mortgage.

(8) The original mortgage did not purport to cover the oil in place, and therefore it was not mortgaged.

(9) An Oil Division Order or Transfer Order is not a pledge or a mortgage or an assignment of oil, unless it be an assignment of oil to the pipe line company purchasing the oil. It is not an assignment of oil to the creditor. The order is directed to the pipe line company. It orders the pipe line company to distribute the *proceeds* of the oil, when produced and delivered to the pipe line, to named individuals in stated percentages. The pipe line company is not indebted to the creditor when the order is signed.

If the order should be held to be an assignment to the creditor, it is only an assignment of an account receivable, that is of sums to become due in the future.

(10) In 1949 Kansas passed what is known as "Accounts Receivable Act" whereby a creditor could protect an assignment of accounts receivable. The creditor Bank, Appellant and Appellee did not take the steps to protect the assignment of accounts receivable as provided by the Laws of Kansas. Therefore under the Federal Bankruptcy Act as amended in 1950, and under Sections 60a (2), (4), (6) and (7) the division orders and transfer orders are deemed to have been made immediately before the Petition in Bankruptcy was filed and therefore constitute void-

able preferences. In such event the Trustee in Bankruptcy is entitled to the proceeds of all oil runs from all the leases.

(11) The Court of Appeals erroneously held that the creditor Bank, Appellant and Appellee, was entitled to all the oil runs from all the leases, and erroneously held that the two later chattel mortgages given as assignments of additional collateral security which were not filed as chattel mortgages were valid as against the Trustee in Bankruptcy, particularly so, as to the purely personal property such as buildings, structures, tanks, pipes, valves, gauges, fillings, pumps, motors, and similar property and equipment which were not even described in the later two mortgages not filed as chattel mortgages. The mortgagee was never in possession of the leases or property thereon or oil produced therefrom.

(12) The Court of Appeals erred in denying the Petition for Rehearing filed in said Court by Petitioner herein.

There is but one record for the appeal and cross-appeal. Both appeals were argued together, and but one opinion rendered which covered both appeals.

IV.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT.

(1) The Court of Appeals, Tenth Circuit, has decided an important question of local law in a way probably in conflict with applicable local decisions of the State of Kansas, in that said Court of Appeals has held that a chattel mortgage which has not been filed as a chattel mortgage and the possession of the property has remained in the mortgagor is valid, notwithstanding the fact that the

Statutes and decisions of Kansas directly and unequivocally declare such a mortgage to be absolutely void as to creditors and as against purchasers and mortgagees in good faith.

(2) The matters involved are of general public interest. In one of the briefs filed by Respondent in the lower Court the importance of the question involved is thus stated:

> "May we respectfully say to the Court that oil financing based on production loan must be ceased by all banks and insurance companies if the strained construction urged by the Receivers is adopted. Thousands of oil producers will be forced into bankruptcy because the loan value of their leases as security will be negligible if production is eliminated."

(3) The matters involved are of great importance to the oil industry which is vitally concerned with the national defense effort and to banks, lending agencies and oil well supply houses, as well as oil developing and producing companies.

CONCLUSION AND PRAYER.

Wherefore, your Petitioner prays that a Writ of Certiorari issue under the seal of this Court, directed to the Court of Appeals for the Tenth Circuit, commanding said Court to certify and send to this Court a full and complete transcript of the record and of the proceedings of the said Circuit Court had in the cases Nos. 4401 and 4402 entitled on its Docket—Case No. 4401, Riverview State Bank, a Corporation, Appellant, vs. R. H. Ernest, Trustee in Bankruptcy for National Petroleum Reserves Corporation, Bankrupt, Appellee, and case No. 4402, R. H. Ernest, Trustee in Bankruptcy for National Petroleum Reserves Corpora-

tion, Bankrupt, Cross-Appellant, vs. Riverview State Bank, a Corporation, Cross-Appellee, to the end that said causes may be reviewed and determined by this Court as provided for by the Statutes of the United States; and that the judgment herein of said Circuit Court be reversed by the Court, and for such further relief as to the Court may seem proper.

Dated October 7, 1952.

WESLEY E. BROWN,
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Attorney for Petitioner.

DONALD C. MARTINDELL,
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RIVERVIEW STATE BANK, A CORPORATION, RESPONDENT.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

REFERENCE TO OFFICIAL REPORT.

The United States District Court for the District of Kansas did not render a written opinion in this case and the case is not reported in the Federal Supplement. The District Court did make its order after careful consideration and review sustaining the orders of the Referee.

The original opinion of the Referee is set out in full (R. 44 to 46) and the Referee's opinion on motion for new trial is set out in R. 47 to 55.

The opinion of the Court of Appeals has not been reported in the Federal Reporter, but appears in the record (R. 59 to 69).

II.

JURISDICTIONAL STATEMENT.

The statutory provision believed to sustain the jurisdiction of this Court is Section 1254 of Title 28 of the United States Code. The Statute of the State of Kansas which is rendered nugatory by the decision of the Court of Appeals of the Tenth Circuit is *Section 58-301, General Statutes of Kansas of 1949*, the applicable portions of which read:

> "Every mortgage or conveyance intended to operate as a mortgage of personal property, which shall not be accompanied by an immediate delivery and be followed by an actual and continued change of possession of the things mortgaged, shall be absolutely void as against the creditors of the mortgagor, and as against subsequent purchasers and mortgagees in good faith, unless the mortgage or a true copy thereof shall be forthwith deposited in the office of the register of deeds of the county in which the mortgagor resides, and also in the county where the mortgaged property is located at the time the mortgage is executed * * * but if the mortgagor does not reside in this state then the mortgage shall be recorded in the county in which the mortgaged property is situated at the time the mortgage is executed."

The date of the judgment sought to be reviewed by certiorari is July 18, 1952, based upon an opinion rendered by the Court of Appeals of the Tenth Circuit,

July 10, and amended July 18, 1952, in cases Nos. 4401 and 4402. Case No. 4401 being entitled in said Court, Riverview State Bank, a Corporation, Appellant, vs. R. H. Ernest, Trustee in Bankruptcy for National Petroleum Reserves Corporation, Bankrupt, Appellee, and case No. 4402 being entitled in said Court, R. H. Ernest, Trustee in Bankruptcy for National Petroleum Reserves Corporation, Bankrupt, Cross-Appellant, vs. Riverview State Bank, a Corporation, Cross-Appellee, and the judgment of said Court rendered August 4, 1952, overruling the Petition for Rehearing filed in said causes, said cases having been appealed upon one transcript of the record, consolidated for argument and one opinion filed covering both cases. The date of this application for certiorari is October 7, 1952.

STATEMENT OF CASE.

The statement of the case is set out in heading I of the Petition for writ of certiorari, which for brevity and to save repetition is made a part hereof the same as if repeated herein in full.

SPECIFICATION OF ERRORS.

1. The Court of Appeals erred in holding that a mortgage of an oil and gas lease in Kansas need not be filed as a chattel mortgage to be valid as against creditors and subsequent mortgagees and purchasers in good faith when the mortgagor remains in possession.

2. The Court of Appeals erred in virtually annulling Section 58-301, General Statutes of Kansas, 1949, which provides that a chattel mortgage is *absolutely void* as to creditors and subsequent mortgagees and purchasers in

good faith unless filed as a chattel mortgage when the mortgagor remains in possession of the mortgaged property.

3. The Court of Appeals erred in holding that purely personal property used in drilling and producing oil on property described in an oil and gas lease was covered by a chattel mortgage which did not describe such property, and which chattel mortgage was not filed as such.

4. The Court of Appeals erred in holding that Respondent was entitled to all the oil runs from all of the leases described in the various chattel mortgages, and in denying the Trustee in Bankruptcy, Petitioner herein, from any recovery in this action.

5. The Court of Appeals erred in overruling the Petition of the Trustee in Bankruptcy for a rehearing.

SUMMARY.

In addition to the Statement of the Case as above set out it should be pointed out that it is necessary to establish several preliminary principles of law to reach the proper ultimate conclusions in these cases.

The ultimate questions to be decided are:

1. In Kansas is a mortgage of an oil and gas lease prior to the rights of a Trustee in Bankruptcy when it is recorded as a real estate mortgage only, and not filed as a chattel mortgage as required by the Laws of Kansas, and the mortgagee was *never* in possession of any of the mortgaged property.

2. Can personal property, such as machinery, casing, drilling and producing equipment placed on property described in an oil and gas lease and which, under the lease,

the lessee has a right to remove at any time, be charged with a lien under a mortgage which *does not* describe such property, and which was never filed as a chattel mortgage, when the mortgagee never was in possession of such property, as against a Trustee in Bankruptcy?

3. Does a mortgage on an oil and gas lease constitute a valid lien upon oil and gas in the ground?

4. Are transfer orders and division orders voidable preferences under the Bankruptcy Act and the Laws of Kansas?

ARGUMENT.

Petitioner desires to take up, briefly and pointedly, the questions presented in the order set out in the petition for writ of certiorari. The first two questions being conceded no time will be devoted to them. Herein the Respondent is referred to as "The Bank."

Oil Lease Personal Property.

No matter what other states may hold as to the nature of an oil and gas lease, Kansas is definitely committed to the position that an oil and gas lease is personal property.

The Reconstruction Finance Corporation, hereafter referred to as R. F. C., and The Bank recognized said fact. The R. F. C. required an examination of the chattel mortgage records before making the loan, and also required the filing of the mortgage as a chattel mortgage and The Bank filed its original chattel mortgage as such, and also filed the renewal affidavits required as to chattel mortgages.

The Kansas Law is clearly stated in *Connell* v. *Kanawa Oil, Inc.*, 161 Kan. 649, 170 Pac. 2d 631, decided in 1946, where it is stated:

"At the very outset in the presentation of his contention an overriding royalty interest is land, probably because of the fact there can be no question but what such an interest is carved out of an oil and gas lease and hence can rise no higher than its source, appellant, with commendable candor, recognizes a doctrine prevailing in this state which, unless its force and effect can be avoided, presents an insurmountable barrier to the successful establishment of his position. He states that under our decisions no extended discussion regarding the nature of an oil and gas lease is necessary and concedes the estate created by such an instrument is an incorporeal hereditament. *We go further and say, whatever the situation may be elsewhere and irrespective of how the present personnel of this tribunal would decide the question if it were one of first impression, that since Zinc Co.* v. *Freeman*, 68 Kan. 691, 75 Pac. 995, *down to the present time this court has definitely committed itself to the doctrine—even to the extent it can be said to be an established rule of property and must be adhered to—that an oil and gas lease conveys no interest in the land therein described but merely a license to explore, and is personal property—an incorporeal hereditament—a profit a prendre*" (Emphasis added).

Other Kansas cases directly in point, and to the same effect, are:

Supply Co. v. *McLeod*, (1924) 116 Kan. 477, 227 Pac. 350.

Burden v. *Gypsy Oil Co.*, (1935) 141 Kan. 147, 40 Pac. 2d 463.

Fry v. *Dewees*, (1940) 151 Kan. 488, 99 Pac. 2d 844.

Wilson v. *Holm*, (1948) 164 Kan. 229, 188 Pac. 2d 899.

In the *Burden case, supra*, the Kansas Supreme Court said:

"It has likewise been held that an oil and gas lease is an incorporeal hereditament and that as such it is personal property" (citing cases).

In the *Fry case, supra,* the Kansas Supreme Court said:

"The two oil and gas leases to Lauck conveyed no interest in the land described, but merely a license to explore, *and were personal property* (*Burden* v. *Gypsy Oil Co.*, 141 Kan. 147, 150, 151, 40 Pac. 2d 463, and cases cited). The oil that may be produced under these leases is personal property" (Emphasis added).

In the *Wilson case, supra,* it is stated:

"These decisions, because of the rule in this jurisdiction that an oil and gas lease conveys no interest in land described but *is personal property*—an incorporeal hereditament—a profit *a prendre* (*Connell* v. *Kanawa Oil, Inc.*, 649 Kan. 469, 170 Pac. 2d 631) are not decisive of the case at bar" (Emphasis added).

There is no question whatever but that for taxation purposes oil and gas leases and oil and gas wells producing or capable of producing oil or gas, and the personal property pertaining to the oil and gas leases, are personal property. *Section 79-328, G. S. Kan., 1949,* reads:

"*Improvements on leased lands not part of realty.* That all improvements put on leased lands that do not become a part of the realty shall be assessed to the owner of such improvements as personal property, and the taxes imposed on such improvements shall be collected by levy and sale of the interest of such owner, the same as in all other cases of the collection of taxes on personal property. (G. S., 1868, Ch. 55, Sec. 31 Oct. 31; R. S., 1923, Sec. 79-328.)"

The above quoted statute relates to all improvements on leased lands and, therefore, covers not only oil and gas leases but the usual farm leases, building leases and residential leases.

The following section, which relates specifically to oil and gas properties (*79-329, G. S. Kan., 1949*), reads:

> "*Oil and gas property as personalty.* That for the purpose of valuation and taxation, all oil and gas leases and all oil and gas wells, producing or capable of producing oil or gas in paying quantities, together with all casing, tubing or other material therein, and all other equipment and material used in operating the oil or gas wells are hereby declared to be personal property and shall be assessed and taxed as such. L., 1917, Ch. 323, Sec. 1; March 13; R. S., 1923, Sec. 79-329.)

Chattel Mortgage Absolutely Void As to Creditors Until Filed As Such.

The Kansas Statute with reference to filing chattel mortgages is clear and unequivocal. The applicable part thereof is quoted (p. 12) of this Brief.

Please note the first part of the Statute. It reads, with emphasis added:

> "*Every mortgage* or conveyance *intended* to operate as *a mortgage of personal property.*"

It is clear that the original mortgage was intended to operate as a mortgage of oil and gas leases and personal property connected therewith. An oil and gas lease clearly being personal property in Kansas, it is equally evident that the original mortgage was intended to operate as a mortgage of personal property. It was filed as such.

The two assignments of additional collateral security were equally intended to operate as a mortgage on oil and gas leases, that is as a mortgage of personal property. The evident fact is that the original mortgage was the main security for the loan to The Bank and The Bank was careless as to the two later mortgages. The two later mort-

gages were recorded in Ellis and Russell Counties as real estate mortgages only and were not filed as chattel mortgages in either of said counties (R. 5, Paragraph 10). The two later mortgages given as additional collateral security were not accompanied by an immediate delivery and were not followed by an actual and continued change of possession of the things mortgaged (R. 41, Paragraph 3).

The Kansas Statute unequivocally states, that *every mortgage* intended to operate as a *mortgage of personal property* not followed by an actual and continued change of possession "*shall be absolutely void as against the creditors of the mortgagor*, and as against subsequent purchasers and mortgagees in good faith," unless the mortgage or true copy thereof is filed in the proper county.

Stated in another way—a mortgage of personal property is absolutely void as to creditors of the mortgage until it is filed as a chattel mortgage unless there is a delivery followed by an actual and continued change of possession of the property mortgaged.

In other words, since in Kansas an oil and gas lease is personal property, a mortgage on an oil and gas lease not filed as required by law *is absolutely void as to creditors* unless there is a continued change of possession. The decision of the Court of Appeals renders the Kansas Statute nugatory—it annuls that statute.

As to creditors the invalidity of the mortgage does not depend upon notice or knowledge under Kansas decisions.

The leading Kansas case on this point is *Geiser* v. *Murray*, 84 Kan. 450, 114 Pac. 1046. The syllabus in that case is:

> "If a chattel mortgage or a copy thereof be not deposited in the office of the register of deeds of the proper county, and the mortgagor continue in un-

changed possession of the things mortgaged, the mortgage is absolutely void as against an attaching creditor of the mortgagor, notwithstanding the fact that such creditor has actual notice of the mortgage."

In the opinion the Court said, after quoting the above-quoted statute:

"The language of this statute is wholly free from ambiguity. As against a creditor who acquires a specific lien by the levy of an attachment or execution the chattel mortgagee must either take possession of the property or record his mortgage. Otherwise the mortgage is 'absolutely void' as to such creditor.

"It is argued that the purpose of requiring a chattel mortgage to be filed for record is to give notice of its existence and terms, and that actual knowledge is better than the constructive notice furnished by the record. The legislature appears to have considered this matter and to have made a discrimination in favor of creditors. A subsequent purchaser or mortgagee must acquire the property or lien 'in good faith,' which includes want of notice. But no condition of that kind is attached to the right of creditors. Had any such limitation been intended the statute would have been framed accordingly."

The above case has been followed by the Kansas Supreme Court up to as late as the case of *International Harvester Co.* v. *Champlin Refining Co.*, 153 Kan. 414, 110 Pac. 2d 779, where it is stated at page 420:

"An unrecorded chattel mortgage under Kansas law is ineffective against a creditor with a writ of attachment or execution even though the creditor have actual knowledge of the unrecorded instrument (*Geiser* v. *Murray*, 84 Kan. 450, 114 Pac. 1046)."

The Geiser case has never been reversed or modified, and it, therefore, is still the law of Kansas. The Trustee in Bankruptcy stands in the position of a most favored

creditor and the two later mortgages are absolutely void as to him.

Property Not Described in Mortgage Not Subject to Lien Thereof.

It is axiomatic that, in the absence of express statutory provisions, property must be described in a mortgage before it is subject to the lien created by the mortgage.

The original mortgage did describe all personal property and equipment used on the leases (R. 3 middle Paragraphs). The two later mortgages given as additional collateral security (R. 23 to 26) did not even by inference describe any of the personal property and equipment used on those leases, such as buildings, structures, tanks, pipes, valves, motors and the like, all of which are definitely and beyond question personal property and are made so by the provisions of the lease. The lessee at all times had the absolute right to remove such property from the leases.

The Bank admits that the personal property such as machinery, equipment and the like was not described in the two later chattel mortgages but contends that such property became "fixtures" to the lease, and do not need to be described in a chattel mortgage to be covered thereby. The law of "fixtures" relates to real property. We have pointed out that in Kansas an oil and gas lease is personal property and not real property, and that no chattel mortgage was filed in Ellis or Russell County.

Before The Bank can claim a lien by mortgage on personal property as against a Trustee in Bankruptcy it must have a valid chattel mortgage on such property, filed as such, or continued possession of the property. Had the mortgage on the leases been filed as a chattel mortgage

there might be some slight basis for The Bank's contention; but such is not the case. No personal property whatever, except an interest in the leases, was described (R. 25).

The Bank did describe the personal property on the leases in the original mortgage. If unnecessary, why was this done? Such machinery and equipment is not a part of the lease. It can all be removed and the oil lease still continue in full force and effect until its expiration.

It is true that the Kansas mechanics' lien statute gives a mechanics' lien on fixtures and appliances on gas leases a preference over other liens *subsequent* to the commencement of the work. This is purely statutory, and there is no statute making a mortgage on an oil lease a lien on property not described in the mortgage.

In *36 C. J. S.* 889 fixtures are defined as follows:

> "In general, fixtures are articles which were personalty but which by being annexed to realty are regarded as a part thereof."

There is no claim that the drilling machinery and equipment ever became a part of the realty, and the law of fixtures is not applicable here.

Kansas Recording Statutes and Oil and Gas Lease Statutes.

Petitioner contends that the opinion of the Court of Appeals misconstrues the Recording Statutes and the Oil and Gas Lease Statutes of Kansas. Petitioner admits that an oil and gas lease *affects* real estate, and therefore is entitled to be recorded under Section 67-221, General Statutes of Kansas, 1949; that when recorded it imparts notice of the contents thereof, and that subsequent *purchasers* and *mortgagees* (not creditors) purchase with

notice, Section 67-222; and that it is not valid, except between the parties and those having actual notice thereof until recorded, Section 67-223.

It follows that to be valid as to third parties a lessee of an oil and gas lease must record the same, not because the lease is real property, but because it affects real estate. Not so, however, with a mortgage or an assignment of an oil and gas lease. Neither one affects the real estate. Accordingly it is the universal practice to require such leases to be signed by both husband and wife if the land owner is married. It is also the general practice *not* to require the husband or wife of a married lessee to join either in an assignment or mortgage of an oil and gas lease. Why? Because the lease after execution is purely personal property.

The *title* to real estate is affected by an oil and gas lease, but not by the assignment or mortgage thereof. When the lease expires the mortgage on it expires and the assignment is of no more value than the lease.

The Kansas statute *does not require an assignment or mortgage of an oil and gas lease to be recorded to be valid as to third parties,* unless they are instruments whereby real estate may be affected. The foreclosure of a mortgage of an oil and gas lease creates no rights in the land itself that did not exist before the foreclosure. The assignment of an oil and gas lease creates no rights in the land itself which did not previously exist.

Neither the assignment nor foreclosure of an oil and gas lease can expand or contract the rights given by the lease.

Why does the original oil and gas lease "affect" real property? Because it gives the lessee the right to remove

some of the real property. That right is given by the lease, not by an assignment or foreclosure thereof.

Since the *original* lease affects real estate and therefore is subject to being recorded, it was a matter of necessity that the State legislature pass some statutes providing for the release of oil and gas leases of record. These statutes are contained in Chapter 55 of the Kansas General Statutes. The Statute referred to by The Bank in said chapter are Sections 55-203, 55-205 and 55-210.

Said Section 203, provides how the lessee, or *assignee of record* may release an oil and gas lease. Section 205 provides how a lease can be extended beyond its original term—that is by the "owner," whether of record or not, filing an affidavit of production. Section 210 provides how mechanics' liens and mortgages on oil and gas leases may be enforced—that is *in the same manner* as they are enforced against real estate. If such liens and mortgages were against the real estate itself the statute would be unnecessary. Also there is no right of redemption from sheriff's sale as to oil and gas leases or mortgages thereon. This is further evidence that oil and gas leases are not real property.

We call attention to some important differences between the recording statute and the chattel mortgage statute. The recording statute expressly refers to those having actual notice of the instrument, the chattel mortgage does not. The recording statute provides "no such instrument in writing shall be valid except between the parties thereto, and such as have actual notice thereof, until the same shall be deposited with the register of deeds *for record*."

The chattel mortgage statute provides that a mortgage of personal property not followed by actual and

continued change of possession—"shall be absolutely void as against creditors of the mortgagor, and as against subsequent purchasers and mortgagees in good faith" until filed as such.

Nature of Oil and Gas in Place.

Oil and gas are migratory and remain a part of the real estate until actually severed therefrom. The owner of the surface owns the oil and gas in place.

In *Gas Co.* v. *Neosho County*, 75 Kan. 335, 89 Pac. 750, the Supreme Court of Kansas said, at page 339:

> "Such being the scope and purpose of the law, the lease in question brought into existence no state of facts to which it might apply. The lease grants no estate in the land or in the oil or gas which it may contain. It creates an incorporeal hereditament only —a license to enter and explore for oil and gas, and if they are discovered to produce and sever them (Citing cases). *Until discovered and brought to the surface no severance of title occurs. The minerals not only remain a constituent part of the land but they belong to the owner of the surface-soil beneath which they lie.* The lessee has no 'right or title' to them (see *Zinc Co.* v. *Freeman*, 68 Kan. 691, 74 Pac. 119), and they are not separately taxable to him" (Emphasis added).

See also *Burden* v. *Gypsy Oil Co.*, 141 Kan. 147, 40 Pac. 2d 463, and the many cases cited therein.

Lessee of Oil and Gas Lease Cannot Give Mortgage on Oil in Place.

As pointed out in the preceding division of this Brief, the landowner owns the oil in place until the oil is severed. One cannot mortgage that which he does not own or possess in the absence of a statute authorizing such mort-

gage. Oil in place is realty—an oil lease is personal property, a mortgage of personal property is not a mortgage on realty, and certainly is not a mortgage on realty not owned or possessed.

Until 1935, when Kansas passed a statute permitting a chattel mortgage to be given on crops to be planted in the future, a mortgage on a crop not planted was void against attaching creditors. A valid chattel mortgage could not be given on animals not conceived.

See:

Long v. *Hines*, 40 Kan. 220, 16 Pac. 339.
Danville State Bank v. *May*, 126 Kan. 714, 271 Pac. 302.
Holt v. *Lucas*, 77 Kan. 710, 96 Pac. 30.
Schmidt v. *Plummer*, 140 Kan. 436, at 439, 37 Pac. 2d 1.

The case of *Townsend* v. *Allen*, 62 Kan. 311, 62 Pac. 1008, is very similar to the case at bar and it has never been modified. For that reason we quote at length from that case:

> "The owners of a brick-yard leased it to another, and stipulated in the lease that they should retain and hold a mortgage lien on the clay in the bank and upon the brick manufactured therefrom as security for any unpaid rent. The clay intended to be covered by the mortgage was in its natural state, and not severed or set apart in any manner. Afterward the lessee manufactured brick and sold the same while a portion of the rent was unpaid, and an action for the value of the brick sold was brought against the purchaser."

The Court held that the mortgage contract did not create a lien on the brick not manufactured or in exist-

ence when the mortgage was executed. At page 313, the Court said:

> "The general rule is that no one can mortgage property which does not exist or which does not belong to him. It is true parties may make contracts with reference to after-acquired property which will be upheld as between themselves, but such contracts are not to be treated as chattel mortgages. The contention here is that the clay and shale used in producing the brick in controversy were in existence; that these constituted the principal elements which entered into the making of the brick in controversy; and therefore they had a potential existence to which the mortgage lien might attach. It is specifically agreed that the material out of which a thousand brick were made was only worth from twenty to thirty cents, while that amount of brick when completed was worth eight dollars. It is also agreed that the nature of the clay was so completely changed by the process of converting it into vitrified brick that it naturally would never return to its original condition. The attempt to give a chattel mortgage upon the clay in the bank was ineffectual, because there was no severance, no setting apart by marking or otherwise, and being in its natural state it must be regarded as real estate, and we are of the opinion that, under the authority of *Long* v. *Hines*, 40 [illegible] 16 Pac. 339, the brick had no such actual or potential existence when the mortgage was made as to subject them to the lien of the same."

At page 314 the Court stated:

> "While it is held that a valid mortgage may be given on a growing crop, the crop itself has a potential existence and will in due course of time and nature develop and mature; but a crop cannot be said to have an actual or potential existence merely because a person may have soil upon which to grow a crop or seed for that purpose. While the soil and the seed

> are essential, a crop cannot come into existence except by a new intervening act, and except with the assistance of other elements and forces."

Kansas has no statute at present or in the past authorizing the giving of a mortgage on oil to be produced in the future.

It, therefore, appears that a lessee in an oil and gas lease cannot give a valid chattel mortgage on migratory oil in place.

The Kansas Statutes and decisions do not recognize the doctrine of potential existence as applied to chattel mortgages, except as to crops to be planted within 6 months and animals.

Oil in Place Not Covered by Any of the Mortgages.

The original mortgage (except for some descriptions) appears in the Record, pages 13 to 23. The only applicable clauses are 3 (R. 17) 10 and 12 (R. 19). The said mortgage does not purport to mortgage the oil in place. It does provide for the giving of division and transfer orders, and for failure to do so The Bank could foreclose its said mortgage.

The two later mortgages given as additional collateral security (except for certain descriptions) appears in the record pages 23 to 26. Neither mortgage purported to cover the oil in place and did not directly provide for the giving of transfer or division orders. It is true the later mortgages did provide that the leases described therein should be held "under the same terms and conditions, and to the same extent, and as if, said interest in said leases had been included in the property mortgaged in the above-described mortgage" (The original mortgage). The original mortgage was never filed or recorded in Ellis or Russell County.

Even if the oil in place could be mortgaged by the lessee, it was not included in any mortgage and therefore was not mortgaged.

Nature of Transfer and Division Orders.

A transfer or division order is directed to the purchaser of oil from a tank or at the pipe line. It is not directed to any one else. The order merely authorizes the pipe line company to receive and purchase the oil and the oil becomes the property of the pipe line company when received by it. The pipe line company is to give credit for the oil and distribute the *proceeds* of the oil in stated percentages to named parties.

The Bank never had possession or ownership of any oil, no oil was assigned to it. The oil in the tank was never mortgaged. The transferor in the transfer order states that he *has* sold an interest in oil produced from a certain lease. But no instrument of sale appears in the record and none was issued. The transfer order is not delivered to the transferee but to the oil company purchasing the oil. The purchaser of the oil does not become indebted to anyone until the month following the purchase of the oil.

A transfer or division order is neither a chattel mortgage nor a pledge nor an assignment of oil to The Bank. They are nothing more than they state—an *order* to pay *in the future* as oil is purchased.

The record (R. 24, 2nd paragraph) shows that no oil was produced from the leases in Ellis County. The leases in Ellis County were unitized with other leases not covered by the mortgage given as additional collateral security. The Bank had received oil runs under the unitization agreement, but not from oil produced from the

leases in Ellis County which were described in the mortgage. The Bank, therefore, had no mortgage on the oil produced in Ellis County because it had no mortgage on the lease from which oil was produced.

The fact that various leases were unitized emphasizes the migratory nature of oil, and that oil is not owned by a lessee while "in place."

Division and Transfer Orders Constituted Voidable Preferences.

We have pointed out that oil "in place" is not personal property, is not owned or possessed by the lessee in an oil and gas lease and therefore is not covered by a chattel mortgage. The "oil runs" were not mortgaged or pledged. The transfer orders assigned the oil "when produced" to the pipe line company, not The Bank. The lessee had the right to receive its share of the proceeds of the oil sold. As the oil was sold it had an account receivable so far as the pipe line purchaser was concerned, nothing more.

The most The Bank can claim is that by the transfer orders the lessee assigned these accounts receivable to The Bank, as security for a debt. In 1949 the Kansas Legislature enacted what is known as the "Accounts Receivable Act" which appears as Article 8 of Chapter 58 of the General Statutes for 1949. Pertinent portions of the Act are as follows:

> "(1) 'Assignor' means, and as used herein is limited to, any person, firm or corporation engaged in selling goods, wares or merchandise at wholesale, or in job lots, and also any person, firm or corporation engaged in manufacturing, processing or assembling goods, wares or merchandise for sale other than at retail.

"(2) 'Account' or 'account receivable' means an existing or future right to the payment of money other than for the repayment of a deposit, or which right to payment is not of a special class, the assignment of which is subject to special statutory provisions of the state or federal government relative to the rights of creditors of the assignor or of successive assignees from the assignor.

"(5) 'Assignment' means any transfer of an account other than by operation of law, including a transfer as security, and the creation by agreement of a lien on an account."

Section 2 of the Act provides the manner by which an assignee may protect his assignment of accounts receivable and for renewal thereof, and Section 3 sets out the effective period of the notice.

Sub-division (1) of Section 4 provides:

"(1) A written assignment for value, signed by the assignor, becomes protected at the time the assignee (a) files a notice of assignment after taking an assignment or (b) takes an assignment during the effective period of the notice. It remains protected while notice of assignment, a renewal thereof, or an affidavit of continuance, or a renewal thereof is effective * * *."

The assignor is the lessee in the oil leases. The right to receive pay for the oil as sold is an account receivable, and the pipe line company is the debtor, and the transfer order was given as security. The Bank is the assignee of an account receivable. The assignment was not protected as provided by the laws of Kansas, but could have been so protected, no notice of the assignment was given to anyone.

Section 60a (2) of the Bankruptcy Act provides in part:

"(2) For the purposes of subdivisions a and b of this section, a transfer of property other than real property shall be deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee. * * * If any transfer of real property is not so perfected against a *bona fide* purchase, or if any transfer of other property is not so perfected against such liens by legal or equitable proceedings prior to the filing of a petition initiating a proceeding under this Act, it shall be deemed to have been made immediately before the filing of the petition."

Sub-section (4) of 60a provides:

"(4) A lien obtainable by legal or equitable proceedings upon a simple contract within the meaning of paragraph (2) is a lien arising in ordinary course of such proceedings upon the entry or docketing of a judgment or decree, or upon attachment, garnishment, execution, or like process, whether before, upon, or after judgment or decree and whether before or upon levy. It does not include liens which under applicable law are given a special priority over other liens which are prior in time."

Sub-section 6, as amended in 1950, provides:

"The recognition of equitable liens where available means of perfecting legal liens have not been employed is hereby declared to be contrary to the policy of this section. If a transfer is for security and if (A) applicable law requires a signed and delivered writing, or a delivery of possession, or a filing or recording, or other like overt action as a condition to its full validity against third persons other than a buyer in the ordinary course of trade claiming through or under the transferor and (B) such overt action has

not been taken, and (C) such transfer results in the acquisition of only an equitable lien, then such transfer is not perfected within the meaning of paragraph (2). Notwithstanding the first sentence of paragraph (2), it shall not suffice to perfect a transfer which creates an equitable lien such as is described in the first sentence of paragraph (6), that it is made for a valuable consideration and that both parties intend to perfect it and that they take action sufficient to effect a transfer as against liens by legal or equitable proceedings on a simple contract: *Provided, however,* That where the debtor's own interest is only equitable, he can perfect a transfer thereof by any means appropriate fully to transfer an interest of that character: *And provided further,* That nothing in paragraph (6) shall be construed to be contrary to the provisions of paragraph (7)."

The first sentence of the amended paragraph (6) plainly states that: "The recognition of equitable liens where available means of perfecting legal liens have not been employed is hereby declared to be contrary to the policy of this section." This is a statement of policy which should be used in construing the balance of the paragraph.

The second sentence states in substance that if a state law provides for perfecting a lien by an overt act as a condition to its full validity against third persons other than a buyer in due course, and the overt act has not been taken the transfer results in the acquisition of only an equitable lien, and is not perfected within the meaning of paragraph (2).

The third sentence goes even further and states in substance, that even though a transfer is made for a valuable consideration and both parties intended to perfect it and took action sufficient to effect a transfer as against liens legal or equitable proceedings on a simple contract,

still notwithstanding the first sentence of paragraph 2, it does not suffice to perfect an equitable lien.

In the case at bar even though The Bank and the Bankrupt intended to perfect a transfer of the oil runs and took steps to effect a transfer as against liens by legal or equitable proceedings, but did not file the notice of assignment with the Secretary of State, that is, take overt acts to protect such assignment or transfer, the transfer order resulted in only an equitable lien and was not perfected, and the transfer order is deemed to have been made immediately before the petition in bankruptcy was filed and is a voidable preference.

CONCLUSIONS.

1. It having been shown that in Kansas an oil and gas lease, when executed, is definitely personal property, the Court of Appeals erred in holding that a mortgage covering an oil and gas lease, when recorded as a real estate mortgage was valid as against a Trustee in Bankruptcy, without being filed as a chattel mortgage.

2. The chattel mortgage statute of Kansas makes a mortgage intended to operate as a mortgage of personal property *absolutely void* as against creditors of the mortgage until filed as such unless the giving of the mortgage is accompanied by an actual and continued change of possession of the things mortgaged. The mortgagee never had possession of the leases or any thing connected with them. Therefore, the Court of Appeals erred in holding that the two later mortgages not filed as chattel mortgages were valid as against the Trustee in Bankruptcy who occupies the position of a most favored creditor. The Court of Appeals erred in rendering nugatory the Kansas

chattel mortgage statute applicable to the case at bar, and in overruling Kansas decisions.

3. The Court of Appeals erred in holding that personal property moved onto real property described in an oil and gas lease was covered by a mortgage which did not describe the personal property, and which was not filed as a chattel mortgage.

4. Oil division orders and transfer orders do not constitute either chattel mortgages or pledges; they do not assign or transfer the oil in place, or when produced, to the mortgagee of an oil and gas lease; at most they only constitute an assignment of an account receivable to the assignee. The Kansas Statutes provide a method by which an assignee of an account receivable can protect his or its assignment. The assignee not having taken any steps to protect its assignment, the division orders and transfer orders constituted voidable preferences and the Court of Appeals therefore erred in holding that Respondent was entitled to all of the oil runs from all of the leases described in its various mortgages, notwithstanding the two later mortgages were void as to the Trustee in Bankruptcy, and in denying Petitioner any recovery whatever.

5. In view of the foregoing conclusions the Court of Appeals erred in overruling Petitioner's petition for rehearing.

Very Respectfully Submitted,

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